Chapter 7

Prudential requirements and professional indemnity insurance

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7.1 Purpose

7.1.1 G

(1) This chapter builds upon the appropriate resources *threshold condition* set out in paragraph 2D of Schedule 6 to the *Act* (see COND 2.4), which requires *firms* to have appropriate resources including financial resources.

(2) This chapter also builds upon *Principle* 4, which requires a *firm* to maintain adequate financial resources, by focusing upon the adequacy of that part of a *firm's* financial resources that consists of *capital resources*.

(3) The chapter also includes requirements for *firms* to have professional indemnity insurance if they carry on *advice, investigation or representation in relation to a personal injury claim*.

7.1.2 R

A contravention of the *rules* in CMCOB 7.2 or CMCOB 7.3 does not give rise to a right of action by a *private person* under section 138D of the *Act* (and each of those *rules*) is specified under section 138D(3) of the *Act* as a provision giving rise to no such right of action).

7.2 Prudential requirements

General solvency requirement

7.2.1 **R** A *firm* must ensure that it is able at all times to meet its liabilities as they fall due.

General prudential resources requirement

7.2.2 **R** A *firm* must ensure at all times that its prudential resources, calculated in accordance with CMCOB 7.3, are not less than its prudential resources requirement.

Prudential resources: general accounting principles

7.2.3 **R** A *firm* must recognise an asset or liability, and measure its amount, in accordance with the relevant accounting principles applicable to it for the purpose of preparing its *annual financial statements* unless a *rule* requires otherwise.

Prudential resources requirement: firms carrying on other regulated activities

7.2.4 **R** The prudential resources requirement for a firm carrying on a *regulated activity* in addition to those covered by this chapter, is the higher of:

(1) the requirement which is applied by this chapter; and

(2) the prudential resources requirement or *capital resources requirement* which is applied by another *rule* or requirement to the *firm*.

Classification of firms for prudential resources purposes

7.2.5 **R** (1) For the purposes of this chapter, a *firm* which carries on any *regulated claims management activities* other than *seeking out, referrals and identification of claims or potential claims* is:

(a) a "Class 1 firm" if its total income in the year ending on its most recent *accounting reference date* is not less than £1million; and

(b) a "Class 2 firm" if its total income in the year ending on its most recent *accounting reference date* is less than £1million.

(2) A *firm* which carries on no *regulated claims management activities* other than *seeking out, referrals and identification of claims or*

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potential claims is neither a Class 1 firm nor a Class 2 firm, and its prudential resources requirement is specified in ■ CMCOB 7.2.10R.

(3) For the purposes of this chapter, total income only includes income relating to the part of the business which is involved in carrying on *regulated claims management activities* and *ancillary activities*.

(4) Where the *firm* has not yet started to trade, total income is to be calculated based on forecast income included in the budget for the first twelve *months*' trading, as submitted with the *firm's* application for *authorisation*.

Prudential resources requirement for a Class 1 firm

7.2.6 R Subject to ■ CMCOB 7.2.10R, the prudential resources requirement for a Class 1 firm is:

(1) the higher of:

£10,000; and

the *firm's* overheads requirement (see ■ CMCOB 7.2.8R); plus

(2) if the *firm* has held *client money* at any time in the last 12 *months*, the client money requirement (see ■ CMCOB 7.2.9R).

Prudential resources requirement for a Class 2 firm

7.2.7 R Subject to ■ CMCOB 7.2.10R, the prudential resources requirement for a Class 2 firm is:

(1) the higher of:

(a) £5,000; and

(b) the *firm's* overheads requirement (see ■ CMCOB 7.2.8R); plus

(2) if the *firm* has held *client money* at any time in the last 12 *months*, the client money requirement (see ■ CMCOB 7.2.9R).

The overheads requirement

7.2.8 R (1) A *firm's* overheads requirement is an amount that is equal to one sixth of its overheads expenditure.

(2) For the purposes of (1), a *firm's* overheads expenditure is to be calculated as follows:

(a) the *firm's* total expenditure in the period of 12 *months* ending on its most recent *accounting reference date*; less

(b) the total of the following items (if they are included in such expenditure) in that period:

(i) staff bonuses, except to the extent that they are guaranteed;

(ii) *employees'* and *directors'* shares in profits, except to the extent that they are guaranteed;

(ii) other appropriations of profits and other variable *remuneration*, except to the extent that they are guaranteed;

(iv) shared commission and fees payable which are directly related to commission and fees receivable, which are included within total revenue;

(v) interest charges in respect of borrowings made to finance the acquisition of the *firm's readily realisable investments*;

(vi) interest paid to *customers* on *client money*;

(vii) 20% of total marketing expenditure; and

(viii) other variable expenditure.

(3) Where the *firm's* total expenditure in the year ending on its *accounting reference date* was incurred in a period of less than twelve *months*, the items in (2)(a) and (2)(b) are to be calculated on a pro-rated basis to produce an equivalent annual amount.

(4) Where the *firm* has not yet started to trade, the items in (2)(a) and (2)(b) are to be calculated based on forecast expenditure included in the budget for the first twelve *months'* trading, as submitted with the *firm's* application for *authorisation*.

(5) In (2)(b)(vii) total marketing expenditure means spending in the twelve *months* ending on the *firm's* most recent *accounting reference date* on, or relating to:

(a) advertising across different media channels;

(b) digital marketing;

(c) publicity expenses;

(d) advertising agency fees;

(e) public relations consultancy fees;

(f) expenses for promotions offered in connection with services provided by the *firm*;

(g) market research and customer surveys;

(h) publications including printed promotional material such as brochures and leaflets, and the *firm's annual report*;

(i) sponsorships; and

(j) gifts to *customers*.

(6) Where, during a period of six *months*, a *firm's* overheads expenditure, calculated according to (2), decreases by 20% or more relative to the overheads expenditure calculated at the last *accounting reference date*, the *firm* may recalculate its overheads requirement and therefore its prudential resources requirement accordingly.

(7) For the purpose of the recalculation in (6), the *firm's* overheads requirement shall be equal to one third of:

(a) the *firm's* total expenditure in the period of 6 *months* ending on the date it changes its prudential resources requirement; less

(b) the total of the items in (2)(b) (if they are included in such expenditure) in that six *month* period.

(9) A *firm* must notify the *FCA* of any change in its prudential resources requirement within 14 *days* of that change.

The client money requirement

7.2.9 R The *client money* requirement is £20,000.

Prudential requirement for lead generators

7.2.10 R If a *lead generator* holds *client money*, the prudential requirement for the *firm* is the client money requirement (see CMCOB 7.2.9R).

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7.3 Calculation of prudential resources

Eligible prudential resources

7.3.1 R (1) A *firm* must calculate its prudential resources only from the items which are eligible to contribute to a *firm's* prudential resources as set out in the table in CMCOB 7.3.2R.

(2) In arriving at its calculation of its prudential resources, a *firm* must deduct certain items as set out in the table in CMCOB 7.3.3R.

7.3.2 R Table: Items which are eligible to contribute to the prudential resources of a firm

	Item	Additional explanation
1	*Share* capital	This must be fully paid and may include: (1) ordinary *share* capital; or (2) preference *share* capital (excluding preference *shares* redeemable by shareholders within two years).
2	Capital other than *share* capital (for example, the capital of a *sole trader*, *partnership* or *limited liability partnership*)	The capital of a *sole trader* is the net balance on the *firm's* capital account and current account. The capital of a *partnership* is the capital made up of the *partners'*: (1) capital account, that is the account: (a) into which capital contributed by the *partners* is paid; and (b) from which, under the terms of the *partnership* agreement, an amount representing capital may be withdrawn by a *partner* only if: (i) the *person* ceases to be a *partner* and an equal amount is transferred to another such account by the *person's* former *partners* or any *person* replacing that *person* as their *partner*; or (ii) the *person* ceases to be a partner and an equal amount is transferred to another such account by the *person's* former partners or any *person* replacing that *person* as their partner; or (iii) the *partnership* is otherwise dissolved or wound up; and

Item		Additional explanation
		(2) current accounts according to the most recent financial statement. For the purpose of the calculation of capital resources in respect of a *defined benefit occupational pension scheme*: (3) a *firm* must derecognise any *defined benefit asset*; (4) a *firm* may substitute for a *defined benefit liability* the *firm's deficit reduction amount*, provided that the election is applied consistently in respect of any one financial year.
3	Reserves (Note 1)	These are, subject to Note 1, the audited accumulated profits retained by the *firm* (after deduction of tax, dividends and proprietors' or *partners'* drawings) and other reserves created by appropriations of share premiums and similar realised appropriations. Reserves also include gifts of capital, for example, from a *parent undertaking*. For the purposes of calculating capital resources, a *firm* must make the following adjustments to its reserves, where appropriate: (1) a *firm* must deduct any unrealised gains or, where applicable, add back in any unrealised losses on debt instruments held, or formerly held, in the available-for-sale financial assets category; (2) a *firm* must deduct any unrealised gains or, where applicable, add back in any unrealised losses on cash flow hedges of financial instruments measured at cost or amortised cost; (3) in respect of a *defined benefit occupational scheme*: (a) a *firm* must derecognise any *defined benefit asset*; (b) a *firm* may substitute for a *defined benefit liability* the *firm's reduction amount*, provided that the election is applied consistently in respect of any one financial year.
4	Interim net profits (Note 1)	If a *firm* seeks to include interim net profits in the calculation of its capital resources, the profits have, subject to Note 1, to be verified by the *firm's* external auditor, net of tax, anticipated dividends or proprietors' drawings and other appropriations.
5	Revaluation reserves	Revaluation reserves such as reserves arising from the revaluation of land and buildings, including any net unrealised gains for the fair valuation of equities held in the available-for-sale financial assets category.
6	Subordinated loans/ debt	Subordinated loans/debt must be included in capital on the basis of the provisions in this chapter that apply to subordinated loans/debts.
Note:		
1	Reserves must be audited and interim net profits, general and collective provisions must be verified by the *firm's* external auditor unless the firm is exempt from the provisions of Part VII of the Companies Act 1985 (section 249A (Exemption from audit) or, where applicable,	

Item	Additional explanation
	Part 16 of the Companies Act 2006 (section 477 (Small companies; Conditions for exemption from audit)) relating to the audit of accounts.

7.3.3 R Table: Items which must be deducted in arriving at prudential resources

1	*Investments* in own *shares*
2	*Investments* in *subsidiaries* (Note 1)
3	Intangible assets (Note 2)
4	Interim net losses (Note 3)
5	Excess of drawings over profits for a *sole trader* or a *partnership* (Note 3)
Notes:	
1	*Investments* in *subsidiaries* are valued at the full balance sheet value.
2	Intangible assets are the full balance sheet value of goodwill, capitalised development costs, brand names, trademarks and similar rights and licences.
3	The interim net losses in row 4, and the excess of drawings in row 5, are in relation to the period following the date as at which the prudential resources are being computed.

Subordinated loans/debt

7.3.4 R A subordinated loan/debt must not form part of the prudential resources of the *firm* unless it meets the following conditions:

(1) it has an original maturity of:

(a) at least five years; or

(b) it is subject to five years' notice of repayment;

(2) the claims of the subordinated creditors must rank behind those of all unsubordinated creditors;

(3) the only events of default must be non-payment of any interest or principal under the debt agreement or the winding-up of the *firm*;

(4) the remedies available to the subordinated creditor in the event of non-payment or other default in respect of the subordinated loan/debt must be limited to petitioning for the winding-up of the *firm* or proving the debt and claiming in the liquidation of the *firm*;

(5) the subordinated loan/debt must not become due and payable before its stated final maturity date, except on an event of default complying with (3);

(6) the agreement and the debt are governed by the law of England and Wales, or of Scotland or of Northern Ireland;

(7) to the fullest extent permitted under the rules of the relevant jurisdiction, creditors must waive their right to set off amounts they

owe the *firm* against subordinated amounts owed to them by the *firm*;

(8) the terms of the subordinated loan/debt must be set out in a written agreement that contains terms which provide for the conditions set out in this *rule*; and

(9) the loan/debt must be unsecured and fully paid up.

7.3.5 R When calculating its prudential resources, the *firm* must exclude any amount by which the aggregate amount of its subordinated loans/debts exceeds the amount calculated as follows:

a – b

where:

a = the sum of Items 1-5 in the Table of items, which are eligible to contribute to a *firm's* capital resources (see CMCOB 7.3.2R)

b = the sum of Items 1-5 in the Table of items, which must be deducted in arriving at a *firm's* capital resources (see CMCOB 7.3.3R)

7.3.6 G CMCOB 7.3.5R can be illustrated by the examples set out below:

(1)	Share capital	£20,000
	Reserves	£30,000
	Subordinated loans/debts	£10,000
	Intangible assets	£10,000
	As subordinated loans/debts (£10,000) are less than the total of share capital + reserves - intangible assets (£40,000) the *firm* need not exclude any of its subordinated loans/debts pursuant to CMCOB 7.3.4R when calculating its prudential resources. Therefore the *firm's* total prudential resources will be £50,000.	
(2)	Share capital	£20,000
	Reserves	£30,000
	Subordinated loans/debts	£60,000
	Intangible assets	£10,000
	As subordinated loans/debts (£60,000) exceed the total of share capital + reserves - intangible assets (£40,000) by £20,000, the *firm* should exclude £20,000 of its subordinated loans/debts pursuant to CMCOB 7.3.5R when calculating its prudential resources. Therefore the *firm's* total prudential resources will be £80,000.	

7.4 Professional indemnity insurance: personal injury claims management

Application

7.4.1 R This section applies only to *firms* who carry on *advice, investigation or representation in relation to a personal injury claim*.

Requirement to hold

7.4.2 R A *firm* must take out and maintain at all times a *professional indemnity insurance contract* that provides for a level of cover at least equal to the requirements in this section from an *insurer* which is authorised to enter into *professional indemnity insurance contracts* in:

(1) a *Zone A country*; or

(2) the Channel Islands, Gibraltar, Bermuda or the Isle of Man.

7.4.3 R The *professional indemnity insurance contract* must make provision for cover in respect of any claim for loss or damage, for which the *firm* may be liable as a result of a negligent act, error or omission by:

(1) the *firm*; or

(2) any *person* acting on behalf of the *firm* including *employees*, or its other agents.

7.4.4 R The minimum limit of indemnity per year in the *professional indemnity insurance contract* must be no lower than:

(1) £250,000 for a single claim against the *firm*;

(2) £500,000 in the aggregate.

7.4.5 R (1) Where the *professional indemnity insurance contract* includes an excess, the excess must not be greater than £10,000 per claim.

(2) The *professional indemnity insurance contract* must contain cover in respect of legal defence costs.

(3) The *professional indemnity insurance contract* must provide for continuous cover for all claims:

(a) first made against the *firm* during the period of insurance; or

(b) made against the *firm* during or after the period of insurance and arising from claims first notified to the insurer during the period of insurance.